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What Is a Liability?

A liability is something a person or company owes, usually a sum of money. Liabilities are settled over time through the transfer of economic benefits including money, goods, or services. Recorded on the right side of the balance sheet, liabilities include loans, accounts payable, mortgages, deferred revenues, earned premiums, unearned premiums, and accrued expenses. Even marriages can change your liability.

In general, a liability is an obligation between one party and another not yet completed or paid for. In the world of accounting, a financial liability is also an obligation but is more defined by previous business transactions, events, sales, exchange of assets or services, or anything that would provide economic benefit at a later date. Liabilities are usually considered short term (expected to be concluded in 12 months or less) or long term (12 months or greater).

Liabilities are a vital aspect of a company because they are used to finance operations and pay for large expansions. They can also make transactions between businesses more efficient. For example, in most cases, if a wine supplier sells a case of wine to a restaurant, it does not demand payment when it delivers the goods. Rather, it invoices the restaurant for the purchase to streamline the dropoff and make paying easier for the restaurant.

The outstanding money that the restaurant owes to its wine supplier is considered a liability. In contrast, the wine supplier considers the money it is owed to be an asset.

Other Definitions of Liability

Generally, liability refers to the state of being responsible for something, and this term can refer to any money or service owed to another party. Tax liability, for example, can refer to the property taxes that a homeowner owes to the municipal government or the income tax he owes to the federal government.

Businesses sort their liabilities into two categories: current and long-term. Current liabilities are debts payable within one year, while long-term liabilities are debts payable over a longer period. For example, if a business takes out a mortgage payable over a 15-year period, that is a long-term liability. However, the mortgage payments that are due during the current year are considered the current portion of long-term debt and are recorded in the short-term liabilities section of the balance sheet.

Ideally, analysts want to see that a company can pay current liabilities, which are due within a year, with cash. Some examples of short-term liabilities include payroll expenses and accounts payable, which includes money owed to vendors, monthly utilities, and similar expenses. In contrast, analysts want to see that long-term liabilities can be paid with assets derived from future earnings or financing transactions. Debt is not the only long-term liability companies incur. Items like rent, deferred taxes, payroll, and pension obligations can also be listed under long-term liabilities.

The Relationship Between Liabilities and Assets

Assets are the things a company owns—or things owed to the company—and they include tangible items such as buildings, machinery, and equipment as well as intangible items such as accounts receivable, interest owed, patents or intellectual property.

If a business subtracts its liabilities from its assets, the difference is its owner's or stockholders' equity. This relationship can be expressed as follows:

Assets

−

Liabilities

=

Owner’s Equity

Assets−Liabilities=Owner’s Equity

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However, in most cases, this accounting equation is commonly presented as such:

Liabilities

+

Equity

=

Assets

What Is the Difference Between an Expense and a Liability?

An expense is the cost of operations that a company incurs to generate revenue. Unlike assets and liabilities, expenses are related to revenue, and both are listed on a company's income statement. In short, expenses are used to calculate net income. The equation to calculate net income is revenues minus expenses.

For example, if a company has more expenses than revenues for the past three years, it may signal weak financial stability because it has been losing money for those years.

: Expenses and liabilities should not be confused with each other. One is listed on a company's balance sheet, and the other is listed on the company's income statement. Expenses are the costs of a company's operation, while liabilities are the obligations and debts a company owes.

Examples of Liabilities

As a practical example of understanding a firm's liabilities, let's look at a historical example using AT&T's (NYSE: T) 2012 balance sheet.